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Innovations in the German SME securitisation market

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This chapter describes the changes that the German small and medium-sized enterprise (SME) securitisation market has undergone in recent years. The focus is on SME securitisation, as opposed to other asset classes such as commercial mortgage-backed securities or auto loans which are also important in the German securitisation market. In the first section, we briefly describe the situation up to 2004. In the next section, we deal with the innovations that took place between 2005 and 2007. The last part describes the impact of the current sub-prime crisis on SME securitisation in Germany.

The situation up to 2004

Before Basel II, the main reason why banks securitised balance-sheet SME loans was to obtain regulatory capital relief. The PROMISE deals are a typical example: PROMISE is a platform sponsored by Kreditanstalt für Wiederaufbau (KfW), a state-owned bank with a regulatory risk weight of zero. Via this platform, various banks issued synthetic collateralised loan obligations (CLOs) with KfW acting as an intermediary between banks and capital markets investors. True sale securitisation deals were of less importance in Germany. This was mainly due to tax uncertainties: special purpose vehicles (SPVs) were potentially subject to trade tax, which would have made true sale deals potentially economically inefficient. In 2004, after these tax impediments were abolished, the True Sale Initiative was launched to promote true sale deals and to establish a common platform that would allow market participants to structure deals in a standardised way. Since then, a number of deals have been issued via this platform.

Table 1

	GATE 2004-1	GATE 2005-1	GATE 2005-2	GATE 2006-1
Portfolio size	€1 bn German SME loans	€1.5 bn mainly German SME loans	€300 mn German SME loans	€2.1 bn mainly German SME loans
Maturity	5 years	7 years	5 years	10 years
Average rating of the securitised assets	BBB-	BBB-	BB- / B+	BBB
Minimal rating of the securitised assets	BB-	BB-	B-	B+
Single obligor concentrations	1% (AAA to A-) 0.7% (BBB+ to BBB-) 0.35% (BB+ to BB-)	1.2% (AAA to A-) 0.8% (BBB+ to BBB-) 0.4% (BB+ to BB-)	1.8% (AAA to A-) 1.6% (BBB+ to BBB-) 1.0% (BB+ to BB-) 0.6% (B+ to B-)	1.75% (AAA to A-) 1.2% (BBB+ to BBB-) 0.7% (BB+ to BB-) 0.3% (B+)
Tranches sold at closing	mezzanine €30 mn annual excess spread on a 'use it or lose it' basis	equity and mezzanine total €90 mn	equity and mezzanine total €45 mn	full capital structure

Changes in recent years

From around 2005, the German SME securitisation market was shaped by two major new trends:

- Regulatory arbitrage was replaced by true risk transfer; and
- New asset classes were securitised (including mezzanine capital and so-called '*Schuldscheine*', a German peculiarity).

Deutsche Bank's GATE programme provides a good example of the way in which true risk transfer has evolved over time. All these deals are on a blind pool basis, since German banking secrecy prevents originating banks from revealing obligor names. Investors and rating agencies must gain confidence in the originating bank's adequate risk assessment, in particular in the internal rating system. This requires that default statistics, ideally over a full economic cycle,

Table 2

	CART 1 Ltd	CART 2 Ltd
Portfolio size	€1.7 bn mainly German SME loans	€1.2 bn mainly German SME loans
Maturity	8 years	7 years
Average rating of the securitised assets	BBB-	BBB-
Minimal rating of the securitised assets	B-	B-
Single obligor concentrations	7% (AAA to A-, top 5 borrowers only) 5% (BBB+ to BBB-), 3% (BB+ to BB-) 1.5% (B+ to B-)	3.65% (AAA to A-), 3.2% (BBB+ to BBB-) 2.3% (BB+ to BB-), 0.9% (B+ to B-)
Tranches sold at closing	equity and mezzanine up to AAA level	equity and mezzanine total €57 mn

be made available. However, what seems to be a relatively easy statistical exercise at first sight may turn out to be rather complex in practice. As banks have continued to improve their rating methodologies and systems, it has become difficult to get consistent loss data stretching back over longer periods of time. In the long run, of course, banks that can provide good-quality loss data will have a competitive advantage.

GATE 2004-1 was the first deal of this series. A portion of the equity was still kept in the form of an annual excess spread available to investors on a 'use it or lose it' basis, thus exposing investors to timing risk and bringing the mezzanine notes a little closer to equity. GATE 2005-1 was a novel structure in the sense that for the first time equity was sold to investors – this was done on a blind pool basis and only the obligor ratings and industry sectors were disclosed. While the average rating of the underlying assets was BBB- in the case of GATE 2005-1, GATE 2005-2 was a heavily sub-investment deal with an average pool rating of B+. GATE 2006-1 was a sizeable €2.1 billion deal with a maturity of 10 years. By comparing the single obligor concentrations in each of the GATE deals, we see that the capital markets accepted a significant increase of single obligor concentrations over time (see table 1).

The purpose of the CART securitisation programme by Deutsche Bank is to manage actively single obligor concentration risk in the German SME book. Table 2 shows that the CART 1 Ltd and CART 2 Ltd deals make it possible to hedge significant single name concentrations.

For both GATE and CART, replenishment is not done on a 'not to worsen' basis, which leverages potential downward rating migrations that would be adverse for investors, but rather with original portfolio quality - that is, the replenished pool must have at least the original pool quality. This balances the originator's and the investors' interests.

One of the problems of German SMEs is their comparatively low equity ratio, which is partly due to the German tax environment. These companies are mostly too small to attempt to go public. Moreover, they are often owned by families who do not want to share their voting rights with potential shareholders.

Historically, SME lending in Germany was based more on relationship banking than on profitability: often the corporate borrower had only one banking relationship – the so-called *Hausbank*. As a consequence of Basel II, more and more banks have developed internal rating systems and have adopted risk-adjusted loan pricing.

For SMEs with low equity ratios and therefore comparatively high probabilities of default, the need arises to improve their equity ratio and to diversify their funding sources. To meet this demand, a number of securitisation programmes were launched in 2005 to securitise portfolios of mezzanine SME debt. These programmes include PREPS (HVB), CB MezzCAP (Commerzbank), equiNotes (Deutsche Bank/IKB), and others. The mechanism common to all these programmes is that mezzanine debt is originated and warehoused by a bank, awaiting securitisation.

While mezzanine debt certainly improves the situation for senior debt holders, it does not – in contrast to equity – absorb any losses and therefore does not delay insolvency. Loss absorption is achieved via preference shares and participation rights. Preference shares are shares without voting rights (a German peculiarity), and so leave owners in full control of their company. Moreover, they are regarded as equity under International Financial Reporting Standards, while participation rights are regarded as equity under German generally accepted accounting principles. For SMEs that do not need to improve their equity ratios, mezzanine debt can be an attractive means of diversifying their funding and obtaining access to capital markets.

These mezzanine debt securitisation programmes were initiated in 2005 and have continued to evolve since then. Originating banks now offer mezzanine debt as well as preference shares and participation rights, depending on the corporate borrowers' needs. Typically, these deals have limited borrower diversity. To mitigate this, names are disclosed. Due to the subordinated nature of the debt, rating agencies apply some notching to the rating and are very conservative about recovery rates – the assumption is usually 0 per cent.

On the other hand, hybrid lenders may profit from a better information flow. Deutsche Bank/IKB's equiNotes platform provides a good example of this in practice. Borrowers must provide the equiNotes lender with quarterly financial information. Moody's RiskCalc is used to assess the SME's creditworthiness. If the SME rating falls below a RiskCalc equivalent of Baa3, the lender has the right to engage in discussions with the corporate's management. Should the rating fall below Ba3, the lender is given even more comprehensive rights. Such proactive debt management is intended to mitigate a slowly worsening credit quality, but cannot prevent losses due to fraud.

Apart from mezzanine debt, another novel asset class that was recently securitised is the so-called *Schuldschein*, a loan agreement governed by German law. The special feature is that this loan agreement can be traded, thus making it attractive for securitisation. Apart from this feature, *Schuldschein* loan agreements are very similar to bank loans. The benefit for SME borrowers is that they can diversify their funding base, instead of having to rely solely on bank loans.

Impact of the current sub-prime crisis

The current sub-prime crisis has affected all segments of the securitisation market, but the extent varies significantly from segment to segment. While structured investment vehicles are virtually gone, the securitisation of SME debt is affected only to a lesser degree. Since most of the SME CLOs are bought by investors on a buy-and-hold basis, reliable secondary market prices are currently not available.

Instead, let us investigate rating stability. This stability varies by asset type. Balance-sheet SME CLOs have shown a good rating stability with a moderate number of downgrades and upgrades, the upgrades mainly due to amortisations. On the other hand, some of the programmes securitising mezzanine debt have been hit by a number of defaults. Some of the defaulting names appeared in several of these transactions, which has made investors more careful about name overlap. Due to the limited granularity of these programmes and the fact that the defaults happened shortly one after the other, the available excess spread could only partly offset the defaults. Consequently, several of these mezzanine deals were downgraded.

Since balance-sheet SME CLOs have shown a good rating stability, the market for this asset class will recover more quickly relative to other securitisation asset classes. This can also be concluded from the fact that Deutsche Bank was able to close CART 2 Ltd in January 2008 as a private placement. However, we expect that any market recovery will take a considerable amount of time, and we believe that the risk premiums in 2006 and the first part of 2007 were at a historical low and will not be repeated for the foreseeable future. However, we are confident that in the long run German SME CLOs will remain an attractive asset class for investors since they offer a good degree of diversification and contain pure credit risk - that is, no mark-to-market risk of the underlying collateral.

This chapter is taken from previously published Deutsche Bank research.